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TREASURY FOR DEPUTY SECRETARY KIMMITT
STATE FOR EUR/AGS, EUR/ERA

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TAGS: [ECON](#) [EFIN](#) [ETRD](#) [ETTC](#) [GM](#)
SUBJECT: SCENESETTER FOR DEPUTY TREASURY SECRETARY
KIMMITT'S VISIT TO BERLIN

Classified By: EMIN Robert F. Cekuta for Reasons 1.4 (b) and (d).

11. (SBU) Summary: Your return to Berlin comes at a point in the German EU and G-8 presidencies when German policy makers and top officials across the government are evaluating progress and looking to make needed midpoint course corrections for the final sprint to the June G-8 summit and the conclusion Germany's EU Presidency. Building upon your previous meetings with German officials, your engagement with Berlin on Iran sanctions, transatlantic economic partnership (the U.S.-EU Air Transport Agreement), and the status of Germany's structural economic reforms will address key issues ahead of the April 30 U.S.-EU Summit in Washington. End summary.

CONTINUING GERMAN ECONOMIC GROWTH -- FINALLY

12. (SBU) Germany's economic performance continues to improve after years of economic stagnation. Growth figures for 2006 have been revised upwards to 2.7%, the highest rate since 2000. Estimates for 2007 now range from 1.5% in the official (probably understated) projection to 2.8% in the most optimistic forecasts. Continued business confidence in most sectors and increasing consumer optimism due to expected wage increases and falling unemployment have alleviated fears about a strong negative impact from the three percentage points VAT increase in January. Finance Minister Steinbrueck wrote an Op-Ed for the March 15 Wall Street Journal Europe entitled "Germany Rising" which emphasized that Germany is "meeting its responsibilities, not only as Europe's growth engine, but also as a driving force for the world economy."

13. (U) Economic institutes expect real GDP to expand faster than potential output throughout 2007. Production growth is likely to be stimulated by growth in business investment -- partly as a result of the more restrictive depreciation rules for tax purposes that will come into effect in 2008. Private consumption should increase as the labor market continues to improve, with real disposable incomes of private households growing. Exports are expected to expand more slowly than in 2006, in line with slowing global demand. Public finances have improved significantly, due to increased tax revenues that exceed intentionally conservative government forecasts. Taking into account the effect of lower expenditures on social security payments due to increased employment, the government's budget deficit ratio is expected to improve to 0.7% of GDP.

REFORMS

14. (SBU) The government, continuing its course of needed

economic reforms, intends to use the robust economic upswing for further reform measures. Specifically, the government will take advantage of its increased revenues to reduce wage and salary costs by lowering labor-related contributions. Insiders report those tasks are difficult, however, due to deep philosophical differences between the CDU/CSU and the SPD. Ambitious economic and social reforms are also underway that foster innovation, competition, and an investor-friendly environment. Beyond Chancellor Merkel's intent to cut bureaucracy and her government's goal of continued privatization and budgetary consolidation, current reform endeavors are the second stage of the federalism reform initiative, concentrating on readjusting budgetary revenue levels, redistributing equalization funds, and burden-sharing between federal and state governments. The government also finalized major tax reform legislation in March 2007, reducing corporate taxes from 36 to 30 percent. To address social reform, an ambitious health reform bill emerged reflecting a paradigm shift in the German health sector by creating new financing mechanisms, including tax-based supplements and contributions. Deliberations towards a modern framework for education, research and development are still underway as the government seeks to encourage innovation and job creation. At the same time, Chancellery officials suggest the scheduled regional elections in 2008 will make it harder for the Merkel government to make major progress on structural reforms after the end of 2007.

TRANSATLANTIC ECONOMIC PARTNERSHIP

15. (SBU) Chancellor Merkel's Transatlantic Economic Initiative fits both with the need for further economic reforms and with her international political/economic framework. Her initiative to integrate more closely the U.S.

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and EU economies seeks to leverage common values to deepen regulatory cooperation, cut restraints on business, boost growth and the Doha talks, and to build a model for other global economic actors, particularly among emerging market countries. When so many of the EU's leaders are paying lip service at best to the transatlantic partnership, Merkel has actually sought to do something to broaden and revitalize it.

She also views it as a chance to cut some of the red tape that limits business activity and growth in Europe, something we have long been advocating. Through this initiative, the Chancellor wants to establish fixed points of contact at top political level between the EU and Washington to ensure cooperation between regulatory bodies continues beyond the April 30 Summit and the German Presidency. The German Presidency's goal for this Summit is for the U.S. and EU to establish a work program for joint cooperation with the goal of realizing a more integrated transatlantic marketplace. The program would accelerate work in the following areas: regulatory cooperation, energy and climate change, intellectual property rights, investment, securities trade, financial markets, and innovation and technology.

16. (U) Outside the Chancellery, MdB Matthias Wissmann, who you know and will meet on March 18, has supported Merkel's idea of a more integrated transatlantic economic partnership, consulting with her closely over the past nine months. Wissmann has emphasized his proposals -- and Chancellor Merkel's transatlantic economic initiative -- are not in competition with the Doha Round and would lower the regulatory barriers that currently exist between the U.S. and EU through greater cooperation. Germany's leadership as EU and G-8 president, Wissmann believes, puts it in excellent position to lay the foundation for a long-term strategy of closer transatlantic economic cooperation. He said April's U.S.-EU Summit offers the opportunity to bring renewed focus to the economic pillar of the transatlantic relationship. You should be aware, however, that Wissmann's earlier talk of a transatlantic free trade area has been dropped by the Chancellery.

FINANCIAL SECTOR ISSUES

17. (SBU) Financial sector regulations and developments continue to arise at various times in connection with the Merkel Initiative, the G-7/G-8, and even in Steinbrueck's March 15 Op-Ed. Government officials closely watched the February 22 announcement by President Bush's Working Group on Financial Markets. Germany remains uncertain about financial sector innovations, a feeling encapsulated in 2005 when Franz Muentefering, then the Secretary General of the SPD and now the Vice Chancellor and Minister of Labor and Social Affairs, referred to hedge funds as "locusts." The public rhetoric has cooled, but the sentiment persists. Some in the German financial sector also believe hedge funds need to be watched carefully. The Bundesbank, for example, expressed concern about the potential systemic risk posed by hedge funds to international financial markets. Some of Germany's top bankers, along with government leaders, argue transparency is the key to preventing instability in the global financial services industry, placing greater emphasis on systemic risk concerns than on investor protection.

CIVIL AVIATION AGREEMENT AND THE MERKEL INITIATIVE

18. (SBU) U.S. and EU negotiators reached agreement on the Air Transport Agreement on March 2 in Brussels. Signing the Air Transport Agreement at the U.S.-EU Summit on April 30 would give real momentum to Chancellor Merkel's Transatlantic Economic Partnership initiative. The Agreement advances her goal of modernizing and reducing regulation of industry -- in this case, one that touches one-fourth of companies' sales according to the Association of European Airlines. The EU's Transport Council must endorse the terms of the Agreement at its next meeting March 22-23 in Brussels. British Airways and Virgin Atlantic are pressing the UK to veto the Agreement, which would end their exclusivity as the only EU airlines to fly transatlantic routes from Heathrow, Europe's busiest airport. As EU Council President, Germany's continued leadership is critical to persuading other Member States, particularly the UK, to accept the Agreement. Government and Lufthansa officials are stating their support for the Agreement, but we are still working to ensure Germany does not go wobbly and allow the draft Agreement to fail in the March Transport Minister's meeting. Encouraging senior government officials, particularly Chief of the Chancellor's

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Office Thomas de Maiziere, to urge their UK counterparts to support for the Agreement, will help to ensure success at the transport meeting.

IRAN

19. (C/NF) Germany, along with its EU3 partners France and the United Kingdom, has tried since 2004 to bring Iran's nuclear program fully under IAEA safeguards. Given its EU3 role, Germany was engaged with the UNSC permanent five members (P5 1) in achieving the consensus resolution, UNSCR 1737, and is working on follow-on actions after the 60-day period to evaluate Iran's compliance ended February 21. Germany has tended toward a middle line between the U.S./UK and the China/Russia positions, with the overriding concern of not upsetting the consensus.

110. (C/NF) In spite of its engagement with the P5, Germany faces some internal opposition to sanctions with working-level officials seeming more grudging about sanctions on Iran than the ministers and state secretaries. An example of this is action on Iran's Bank Saderat. Senior-level officials in the Ministries of Foreign Affairs, Economy, and Finance agree with U.S. points that the bank is involved with WMD financing. Nevertheless, working-level officials state that because the bank is not on the UNSCR 1737 Annex, the German Government faces legal constraints in sanctioning the bank and can only block those transactions for which legal proof in support for WMD activities is available.

Developments in the UNSC debate over further sanctions should resolve this particular problem.

¶11. (C/NF) Though German firms continue to do business with Iran, with a prime example being Siemens' November 2006 signing of a 450 million dollar railway contract, many have complained to their government that they are being replaced by lower-cost competitors from Asia. Overall German trade with Iran decreased approximately 6 per cent in 2006 while exports and export credit guarantees have fallen over 40 percent since record highs in 2005. Economics Ministry officials cite increased political risk for the decline. The OECD decision to drop Iran from category 4 to category 5 last year -- a step the German Foreign Ministry reports it generated -- reflected the international view that Iran's president is a destabilizing force in the region. German officials also claim that German banks have no interest in increasing exposure while the government continues to examine each export project carefully. Government officials expect the volume of export credit guarantees to drop further in 2007, assuming there is no change in Iranian politics. In November 2006, the German government increased the punitive measures associated with violating export regulations. Should exporters chose to disregard these regulations, they risk losing the coverage provided through the export credits.

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